AEQUITAS INVESTMENT ADVISORS

QUARTERLY LETTER – SUMMER OF 2025

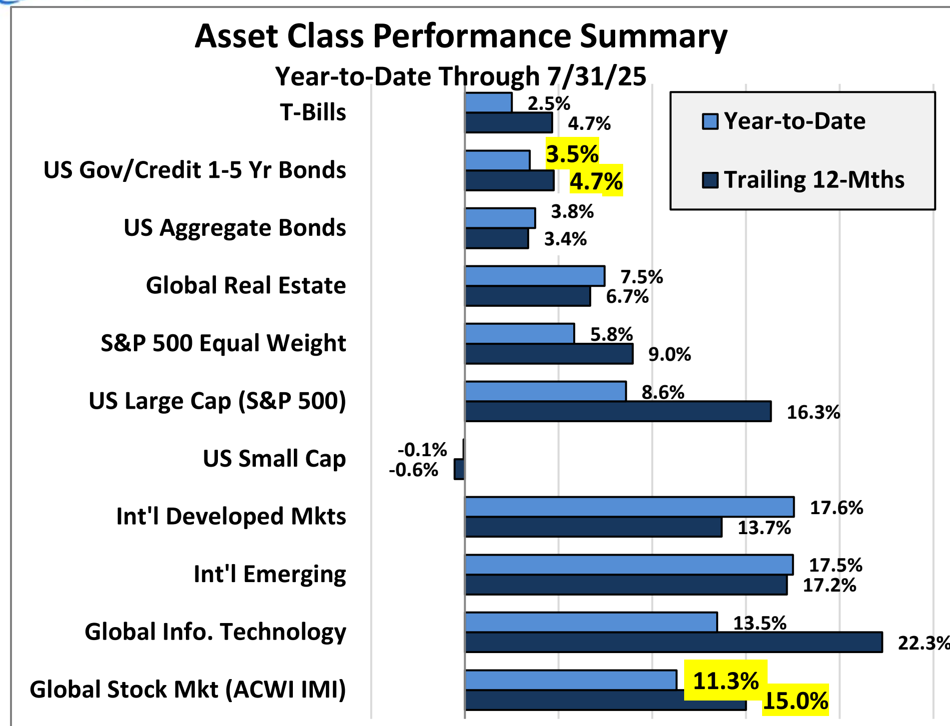
WWW.AEQUITAS-INV.COM 781-740-1199

Warner & Your Team!

Re: Asset Class Performance, Tariffs, Immigration, the Economy, Inflation, and the New Tax Act

Four months ago, following the April 2nd "Liberation Day" announcement of an extreme level of tariff rates on roughly 90 countries, the stock market was in a tailspin. Tariff fears had been building since President Trump took office and by April 8th, for the year-to-date period, the S&P 500 Index was down by 15%, the NASDAQ was down by 20%, and the Global All Country World Stock Market Index was down by 13%. Coming into 2025, most economists assigned a low probability to the risk of an economic recession in 2025, but by April 8th, economists were rapidly raising the odds. Rising recession risks coupled with the president's negative comments about the Federal Reserve, and the prospect of rising government debt levels, added to concerns about the government's creditworthiness. Some investors began selling their U.S. Treasuries given these concerns which prompted Treasury Secretary Bessent to take to the airwaves to calm the markets. On April 9th, at Bessent's urging, the administration announced a 90-day pause in implementing the extreme tariffs to allow time for negotiations. Since those darker days, immediate concerns about the government's creditworthiness have largely subsided, corporate earnings have been relatively strong, consumer sentiment has improved (but still below optimistic levels), and progress has been made in tariff negotiations. As a result, investor sentiment improved sufficiently to propel stock prices to record-high levels by late July.

In this quarterly letter, we will review the recent performance of the various asset classes as well as provide brief updates on tariffs, immigration, the economy and inflation, as well as offer a brief summary of the new tax act (referred to as OBBBA) and some of its key provisions.



Asset Class Performance

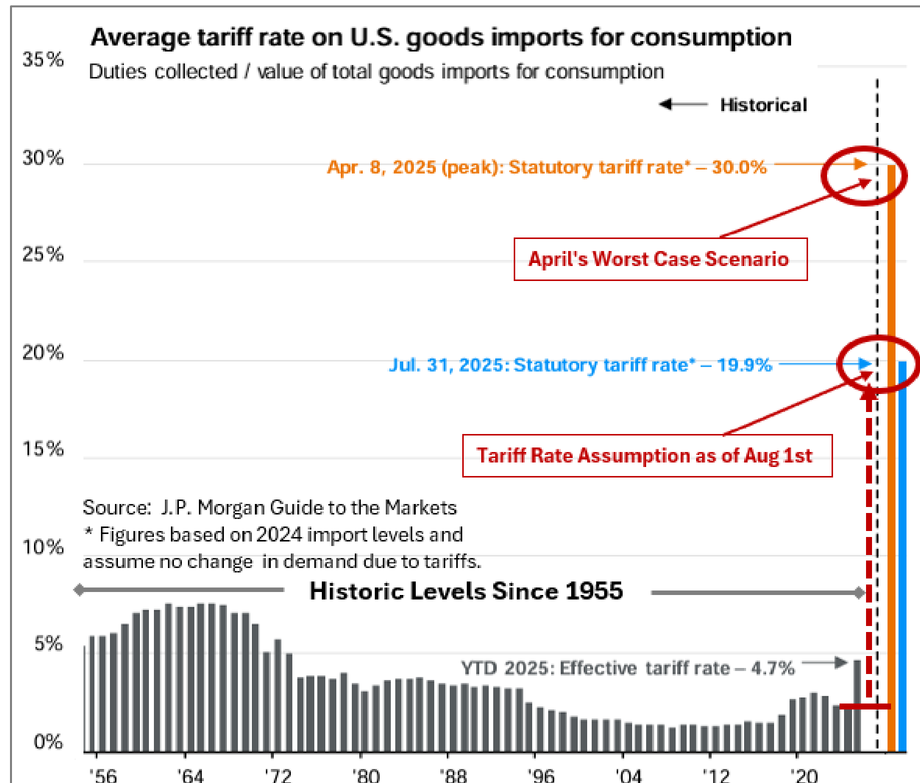
Looking at the performance for the year-to-date period ending July 31st, the volatility we experienced in the month of April is unapparent (one of the benefits of looking at performance over longer periods of time). The Global Stock Market gained 11.3% for the period with U.S. Gov't/Credit 1-5 Year Bonds gaining 3.5%. Leading the way was International Developed Markets (+17.6%) followed closely by Emerging Markets (17.5%). Both asset classes were buoyed by foreign currencies gaining strength against the U.S. Dollar, as well as a reflection of investors moving assets into more favorably priced foreign stocks. The other stock asset class returns ranged from -0.1% (U.S. Small Cap Stocks) to 13.5% for Global Information Technology. U.S. Aggregate Bonds gained 2.9% and U.S. T-Bills gained 2.5%. Considering the volatility in early April, it was a remarkably positive first seven months of the year for stocks and bonds.

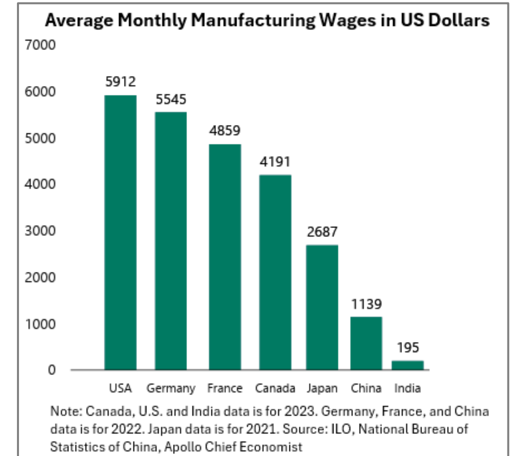
For the trailing 12-month period ending July 31st, the Global Stock Market gained 15% and U.S. Gov't/Credit 1-5 Year Bonds gained 4.7%. Global Information Technology Stocks led the way (+22.3%), perhaps due to this sector's involvement in the development of Artificial Intelligence. The other stock asset classes posted returns ranging from -0.6% (U.S. Small Cap Stocks) to 17.2% (Int'l Emerging Markets). U.S. Aggregate Bonds gained 3.4% while U.S. T-Bills gained 4.7%. The 4.7% twelve-month return for U.S. Gov't/Credit 1-5 Year Bonds is close to its expected return over the next 10 years, whereas the 15% return for the Global Stock Market is considerably higher than its expected 6.6% 10-year future average annual return based upon current valuations. (Note: while U.S. Small Cap Stocks have lagged behind the other stock asset classes recently,

their expected returns over the next 10 years are among the highest of the major asset classes due to their comparatively low and attractive prices.)

Reign of Tariffs

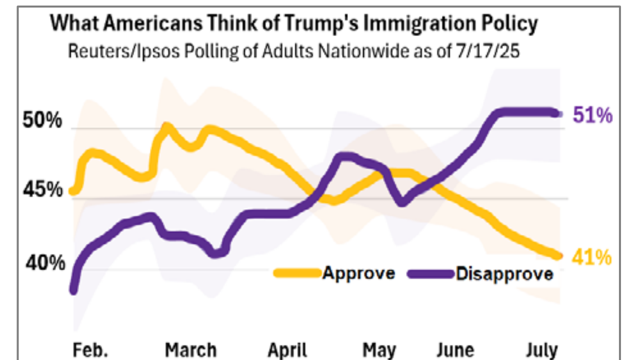
As of July 28th, the Trump administration had made 33 trade deals, including those with the U.K., China, Vietnam, Indonesia, the Philippines, Japan, and the European Union. So far, none of those deals has prompted retaliatory tariffs which would have been much more problematic. While this remains a moving target and is subject to ongoing legal challenges, it now appears that the new baseline average tariff rate will be around 20% (refer to the graph below) rather than what might have been a 30% average rate under the "Liberation Day" set of announcements. It is estimated that the 20% figure might raise more than $400 billion per year of government revenue, at least for the short term. Assuming that the administration does not give the tariff revenue back to taxpayers in the form of "tariff rebate checks" as Trump has recently suggested, or as subsidies to various industry sectors (e.g., as was done for the agricultural sector previously), the revenue should be available to help reduce the federal deficit. However, any revenue generated from tariffs might only be temporary given that businesses will try to work around the tariffs and/or alter their supply chains, and consumers will shift to non-tariffed goods over time resulting in a gradual decline in tariff revenue. This entire tariff ordeal, of course, was never about reducing the deficit. Rather, the stated purpose was to bring manufacturing back to the U.S. which is a worthy goal. However, it will take many years to reshore manufacturing back to the U.S., but in the meantime importers and consumers will be stuck with higher costs. The Budget Lab at Yale estimated that tariffs in 2025 might cost the average four-person household about $2,400. Tariffs are also considered to be a regressive tax in that the higher cost of goods disproportionately impacts lower-income individuals. Furthermore, it is also unclear how many manufacturing jobs will actually be created given that automation and robotics will likely continue to reduce the demand for manual labor jobs with U.S. manufacturing wages being among the highest globally (i.e., a primary reason why manufacturing jobs were offshored to begin with). This is not an argument against the reshoring of manufacturing, rather, it is simply a recognition that the comparatively high cost of creating these jobs will most likely result in higher costs of production, higher consumer prices, and greater use of automation.



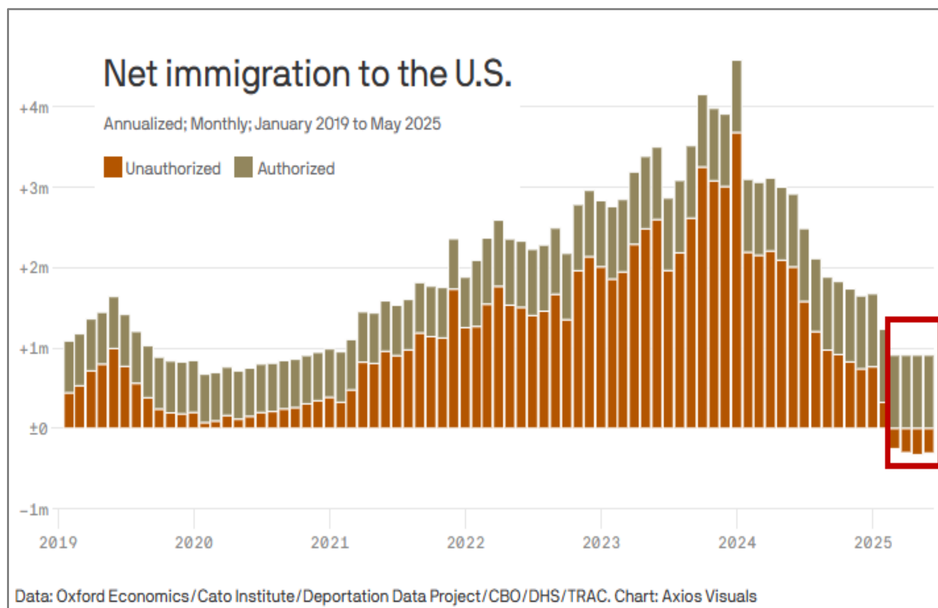


Immigration

By early March of this year, the majority of Americans agreed with Trump's immigration policy of securing the southern border and removing violent criminals. However, that support has completely reversed based upon the most recent polling given the view that the Immigration and Customs Enforcement's (ICE's) deportation dragnet has gone too far by targeting not just violent criminals, as was promised on the campaign trail, but also capturing productively employed undocumented immigrants who have no criminal records. In some cases, even U.S. citizens have been caught up in the dragnet due to racial profiling.

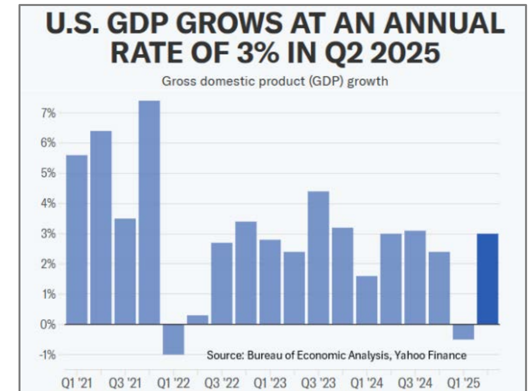


There are an estimated 11 million undocumented immigrants in the U.S. based upon Pew Research Center data. Of that total, about 8.3 million are productively employed representing about 5% of the total U.S. workforce. They make up about 13% of all workers in the construction industry, with agriculture, food service, domestic work, and other service jobs accounting for the balance of their employment. They tend to take jobs that U.S.-born workers are less likely to take. Studies show that we need a minimum of about one million net new immigrants annually for the foreseeable future to maintain the size of our current workforce in order to address the aging population. As the chart below indicates, outflows of unauthorized immigrants netted against authorized inflows over the past few months has resulted in an annualized rate of net inflows of about 600,000 workers which is far below the one million level that we need. With fewer workers producing goods and services, economic growth will slow, and wage pressures will rise. Why not limit the deportations to those with criminal records which are estimated to be about 10% of the undocumented immigrant population? And why not create a commonsense path to citizenship for the vast majority of undocumented immigrants who already reside in the U.S. and are productively employed (and paying taxes into the system)? Perhaps popular opinion will create political pressure in this direction. According to a recent Gallup poll, a record 79 percent of American adults today think immigration is good for the country. And the number of Americans who want immigration reduced dropped sharply from 55% (last year) to 30% today.



The Economy

So how will the impact of the tariffs and shrinking labor supply impact the economy? While the ultimate effect of both of these developments has not been fully realized, it is safe to say that economic growth is expected to slow over the next 6-12 months. On a positive note, at least on the surface, the Bureau of Economic Analysis reported on July 30th that the economy grew at an annualized rate of 3% in the second quarter of 2025. This is a sharp rebound from the prior quarter which saw the economy contract for the first time in three years. However, excluding the volatile trade and inventory contributions to the top line number, the underlying growth rate was closer to 1.1% which represents a sluggish rate of growth. On the global front, the International Monetary Fund (IMF) raised its growth forecast due in part to lower U.S. tariff rate expectations compared April's extreme levels. The IMF forecasts global growth of 3% in 2025 and 3.1% in 2026 with growth in the U.S. expected to be 1.9% in 2025 and 2% in 2026.



Inflation

Federal Reserve Chairperson Jerome Powell opened his press conference on July 30th by saying, "My colleagues and I remain squarely focused on achieving our dual mandate goals of maximum employment and stable prices for the benefit of the American people. Despite elevated uncertainty, the economy is in a solid position. The unemployment rate remains low, and the labor market is at or near maximum employment." Powell went on to say that inflation has been running above the Fed's 2% long-term target and that the full impact of tariffs has not yet been realized in consumer prices. For that reason, the Fed decided not to reduce interest rates in July, but will review the inflation data again in September. Given the disappointing U.S. labor market report published on August 1st, it is now more likely the Fed will begin lowering interest rates in September and continuing into 2026.

The New Tax Act

After reading the initial draft of the new tax act (OBBBA) in late May, Elon Musk vented his disappointment that the bill would significantly increase the federal budget deficit at the time when his DOGE team was searching for ways to reduce government expenditures. "I think the bill can be big or it can be beautiful, but I don't know if it can be both," Musk told CBS News. It now appears that Musk was overly optimistic in his quest to shrink the government and significantly reduce the size of the federal deficit. While Musk is now on the outs with the president for his candid criticism of the bill, we can at least turn our attention toward the bill's key provisions for taxpayers, some of which will expire in 2028. (We will be reviewing pertinent provisions of the bill with our clients in upcoming review meetings.)

- The biggest benefit for most taxpayers is that OBBBA extended the 2017 Tax Cuts and Jobs Act tax brackets indefinitely. Without this act, federal tax brackets would have reverted to the higher pre-2017 brackets. This extension will simply extend the current tax brackets, so most taxpayers will not see any benefits beyond those they are already receiving.
- Beginning in 2026, the estate and gift tax exemption will be increased to $15 million for single taxpayers and $30 million for joint taxpayers. (Note: in 2025, the exemptions were $13.99 million and $27.98 million respectively and they would have been indexed to inflation, so this increased exemption provides a modest benefit.)
- The standard deduction for non-itemizers has been slightly increased, but the bigger benefit is for taxpayers with high state and local taxes (SALT). For those taxpayers, the allowable deduction for state and local taxes has been increased from the current $10,000 to $40,000 beginning in 2025. However, the higher deductible amount is phased out for those with Modified Adjusted Gross Income (i.e., MAGI) of $500,000 for single filers, and $600,000 for joint filers.
- A new deduction has been provided for those aged 65 and older with more modest income levels. Effective this year, senior taxpayers will be eligible to deduct an additional $6,000 ($12,000 for joint filers). This additional deduction is phased out starting at $75,000 of MAGI for single filers and $150,000 for joint filers. (Note: this provision was intended to fulfill the campaign promise of eliminating taxes on Social Security; however, it will only offset a portion of one's Social Security income and higher income taxpayers will receive no benefit from this provision.)
- Deductions for Tips and Overtime Pay. A tax deduction of $25,000 against tip income per taxpayer, but the tip income will still be subject to other payroll taxes. A deduction of $12,500 for single filers, and $25,000 for joint filers against a portion of their overtime pay (i.e., if the taxpayer's hourly pay was $20 and they earned $30 for working overtime, only the additional $10 is eligible for this new deduction). Both of these deductions are phased out beginning with MAGI of $150,000 for single filers and $300,000 for joint filers.
- A new tax deduction for auto loan interest of up to $10,000 for vehicles assembled in the U.S. This deduction is phased out for higher income earners beginning at the $100,000 income level (MAGI) for single filers and $200,000 for joint filers. (Note: a $40,000 three-year car loan with an interest rate of 7% has a first-year interest payment of about $2,400, so one would need to purchase a $165,000 vehicle at 7% for three years to take full advantage of this provision assuming their income was $200,000 or less for joint filers.)

What will be the cost of these new tax benefits and extensions? According to the Congressional Budget Office, the net cost of the OBBBA will be $3.4 trillion cumulatively over the next ten years. The spending cuts of the new bill including those engineered by DOGE will be about $1.1 trillion. The decreased revenue from OBBBA will be $4.5 trillion according to the CBO. These estimates do not include the cost of removing immigrants who would have paid more in taxes than they received in benefits. The CATO Institute estimates that this lost tax revenue, plus the direct and indirect costs of deportations will add $1 trillion to the $3.4 trillion cost of OBBBA over the next ten years. On the other hand, proponents would argue that the OBBBA will stimulate growth and bring in more tax revenue to offset the projected deficits. And while some would argue that the additional revenue from tariffs would also shrink the deficit, most economists forecast that tariffs would slow economic growth resulting in less tax revenue. Regardless of how this all plays out, the problem of continuing to run unsustainably high federal deficits is a significant problem that must be considered in our planning for the future. We will continue to monitor future developments while also looking for strategies to mitigate this growing risk.

Closing Comment

While the economy has displayed remarkable resilience since the volatile days in early April, there remain many uncertainties on the horizon and risks to the outlook. From an investment perspective, we believe that two of the most time-tested ways to manage portfolio risk are (1) to maintain an appropriate balance between Fixed Assets (including cash and bonds) and Equities, and (2) to diversify the Equities globally with a tilt toward stocks with lower prices and higher expected future returns. With these two primary strategies in place along with our regular client reviews and portfolio rebalancing, we believe the chances are significantly improved for achieving a successful long-term investment outcome while fulfilling our clients' financial objectives.